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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
125 East 93rd Street
New York City 28

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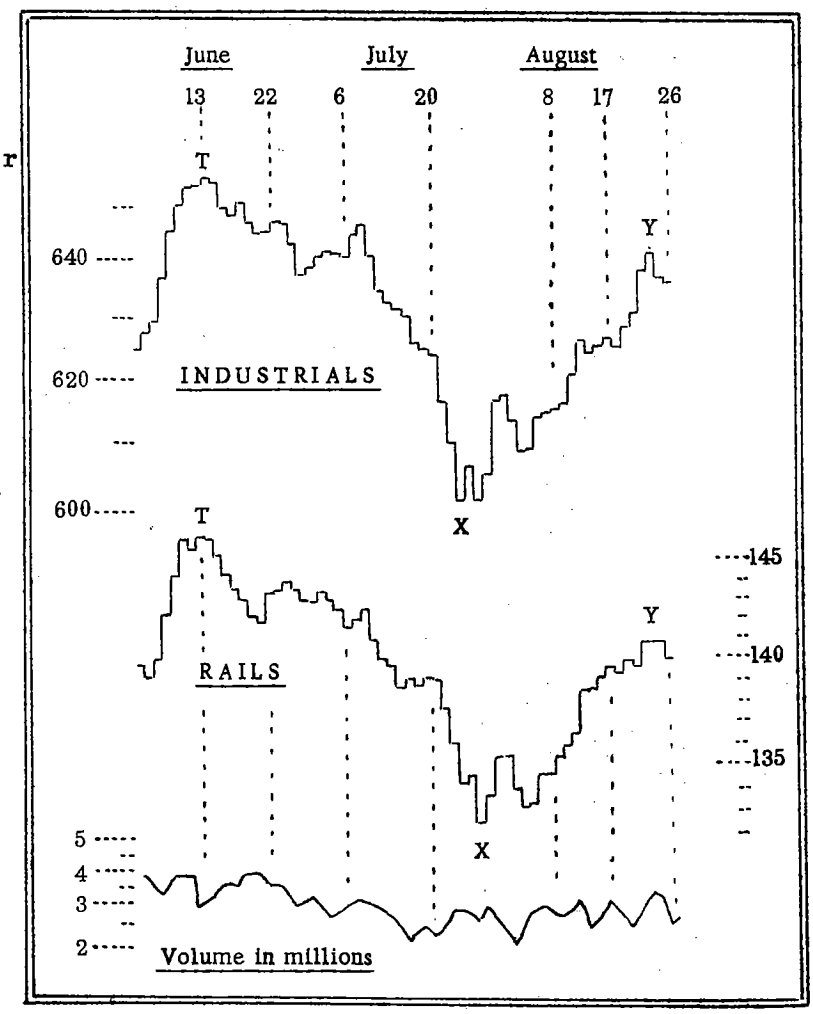
PRICE MOVEMENTS. On the rally from X to Y (see chart), Industrials advanced a remarkable 17 out of 22 days or 77% of the time. Since advancing days normally consume about 46% of all bear markets, it would seem that the decline from Y was greatly overdue.

Letters 112-114 discussed the implications of a penetration of one Average unconfirmed by the other. On the T-X decline Rails violated their preceding bear market low, but Industrials would not confirm. This presented the possibility (see Letter 112) of a full correction of T-X. The correction has taken place, and at Y Industrials had retraced 70% of the losses sustained from T to X, Rails 61%. Thus the rally from X to Y has (so far) been a normal correction of the T-X decline. It is probable, however, that the next sustained c movement of the Averages will be most significant.

Since the March 8 Industrial low point of 599.10, there have been two major attempts by Industrials to penetrate the 599.10 level, one in May and one in July. Both of these attempts were unsuccessful. Following each approach to the lows, a sustained rally occurred, the latest being the rally from X to Y. If the recent minor peaks at Y are to be bettered (and the T highs tested), it is my guess that any decline (correction) from Y will erase no more than 1/3 to 1/2 of the X-Y advance. On the other hand, if, on a decline from Y, the Averages make another close approach to their bear market lows, I believe that the odds will then favor a penetration.



SIFTING THE EVIDENCE. On March 8, 1960, the Industrial Average touched a low of 599.10. In the 5 1/2 months since then the senior Average has fluctuated within a relatively narrow area bordered by the March low (599.10) and the June high (656.42). For the Industrial Average to fluctuate within an 8.7% range for so long a period of time is most unusual.

I have stressed that principle of Dow's Theory which states that the primary trend is taken to remain in force until reversed by an authoritative countersignal. On March 3, 1960, the Averages gave the signal for a primary bear market. This meant that the major direction of stocks and the economy was down. Following the March 8 lows, a secondary (upward) reaction advanced Industrials to 630.77, Rails to 146.56.

In June another rally took Industrials to 656.42, but Rails refused to better 146.56. Becau of the Rails' failure to confirm I wrote that I did not consider the June Industrial high to be a valid prediction of an economic upturn -- but merely an extension of the secondary.

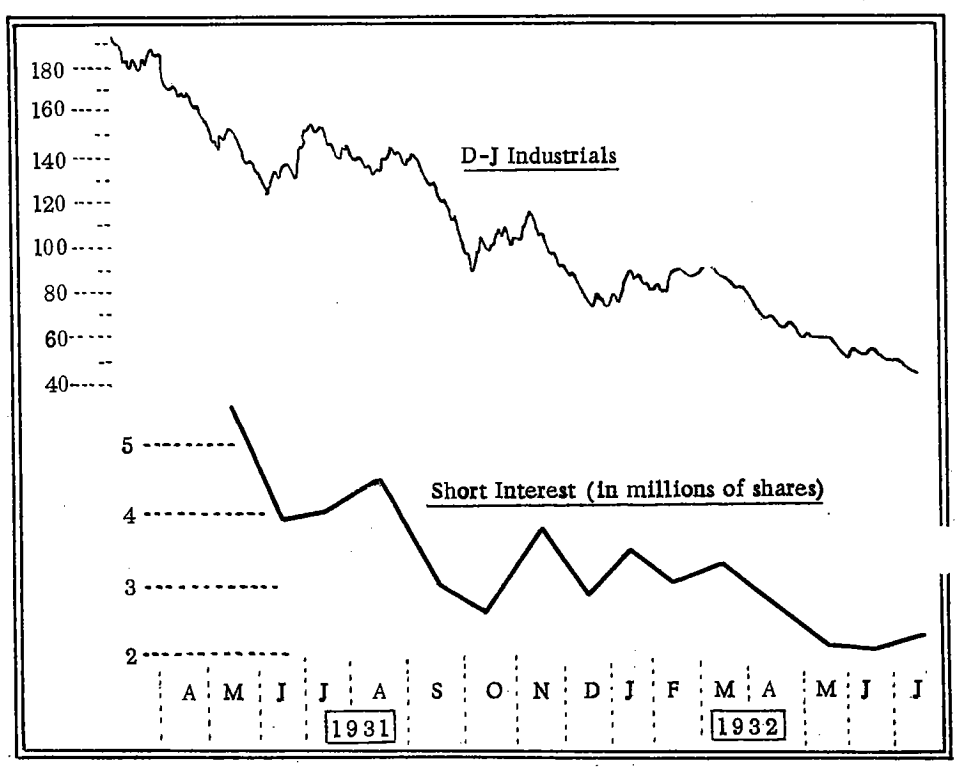
I have been asked whether the current rally (X-Y) is not a prediction of an impending upturn in the economy. My answer is that so far, the rally is not a prediction of anything. Barring an upward penetration of the secondary reaction highs (Industrials 656.42, Rails 146.56), I continue to believe that first consideration should be given the primary trend, which has been and still is bearish.

The rally from the July lows (X) suggests that the market has been discounting the normal tendency of the economy to pick up (at least seasonally) in the fall of the year. If investors sense a forthcoming broad expansion this fall, it is probable that the secondary highs 656.42, 146.56) will be hurdled. If an economic "holding action" is in the cards, the Averages may well continue to fluctuate within the March-August area. If a disappointing fall or a further business contraction is anticipated, the bear market lows will be broken.

SHORT INTEREST The latest (August) short interest figures aroused considerable interest because they showed a rise in the short interest total, thereby reversing the June-July trend. It is important to remember that a high or rising short interest is one thing in a bull market -- in a bear market it is something else again.

When the primary trend is bullish the short seller is speculating against the tide; the longer he holds his shorts the greater the odds in favor of his eventually covering at a loss. A rising short interest in a bull market is a force for technical strength because it indicates that a large number of people are willing to speculate for a major decline against the primary trend. Actually, when a sufficient number of people become convince that a bull market is headed down, it is usually a safe bet that the worst has already been discounted.

Since primary bull markets have been in effect during the majority of the last sixty years and since the public usually remembers the bull markets and forgets the bear markets, there is little wonder that so much significance is attached to a large or growing short interest. During bear markets, however, the shorts are swimming with the tide. In general, the best that a large short interest can do in a bear market is to lay the groundwork for a secondary (upward) reaction or add violence to a rally. And although bear market bottoms are accompanied by the type of depressing psychology which normally attracts amateur shorts, short selling itself cannot reverse the primary trend. A primary bear market turns up only when the worst that can be seen ahead is fully discounted in the price structure.



I have included a chart which traces the price action of the D-J Industrials through 1931 and most of 1932 (a great bear market was then in progress). The chart also shows the total short interest from May, 1931 (when the Exchange first released

the short interest figures) to July, 1932, when the 1929-32 bear market ended.

Students of the short interest should study this chart carefully. Note that in May, 1931, with the Industrial Average at 160, the short interest totalled a whopping 5.5 million shares. Despite this, however, the market headed sharply lower. It is also interesting to see that during the remainder of the bear market or until July, 1932, the shorts tended to be correct. During the May, 1931 to July 1932 period the short interest dropped steadily to a low of just above 2 million shares (in July, 1932, when the bear market ended). In other words, the huge short total in May, 1931, was not a bullish factor for the market; moreover, the short sellers, judging from subsequent market action, were correct throughout most of the period shown.

We have seen a hint of the same phenomenon over the last year. In November, 1959, Studebaker-Packard (SK) had a short interest of 535,000 shares; the stock was then selling at 25. By November the short interest had grown to 603,000, but the stock had dropped to 14. In March SK showed a total of 613,000 shorts, and the stock was 8 5/8. Obviously, an incredible number of shorts have been right about SK, and those who bought SK because of its "excellent technical position" have lost heavily. This sort of thing, of course, is seldom seen in a bull market.

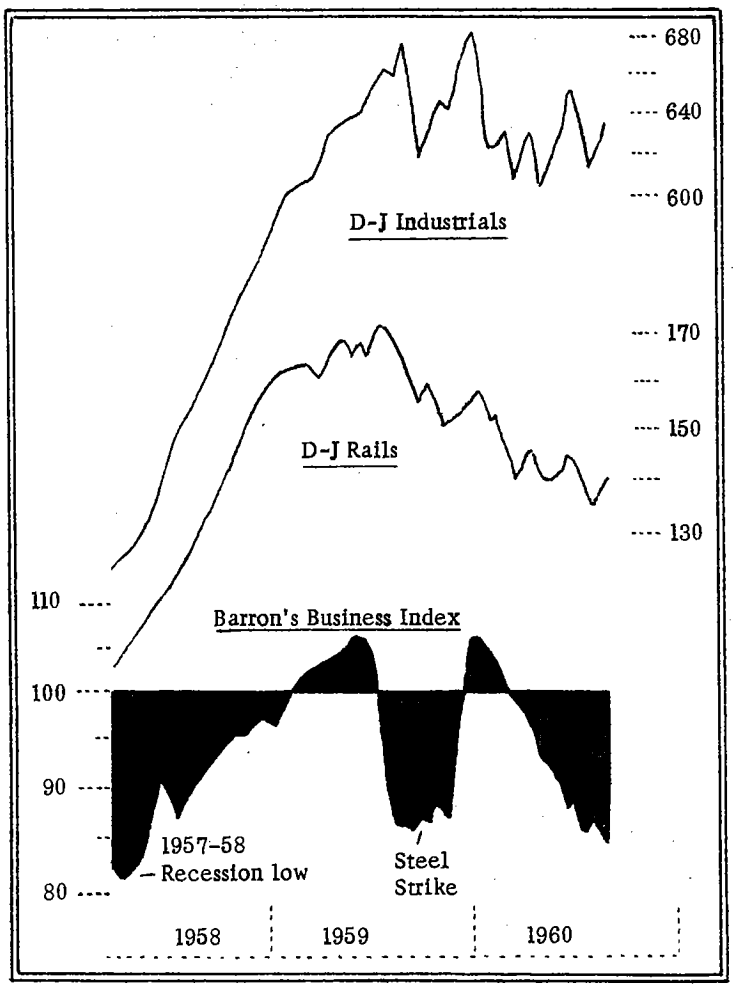
A ROSE BY ANY OTHER NAME --- I am not an economist nor have I ever masqueraded as such. Nevertheless, I have reason to believe that my interpretation of a simple business index is as good as the next man's. Barron's Business Index is one of the oldest and best known of the indices of economic activity; it is properly adjusted for seasonal changes, population growth and long-term trends. My conclusions based on a reading of the recent action of Barron's Business Index may differ from those which are frequently expressed in the newspapers, but this seems as good a time as any to call a spade a spade.

Barron's Index registered a low of 80.8 in April of 1958. At that time "our worst post-war recession" was the most widely discussed topic of the day. Following the April, 1958 low point, Barron's Index entered upon an extended advance which touched a peak of 106.1 in July, 1959, and another peak (subsequent to the steel strike's ending) at 106.6 in January, 1960. From that lofty level, the Index headed down.

This week Barron's Index registered a new 1960 low of 84.2, a figure which is below the 85.8 recorded during the worst of the 1959 steel strike. This means that business is now off 21% from the 106.6 high of January, 1960; it also means that the current level of business is a mere 4% above the low point of the 1957-58 recession.

Barron's Business Index is not an opinion or a hope; it is a mathematical weekly composite of the nation's (1) steel activity, (2) petroleum output, (3) coal production, (4) carloading statistics and (5) electric power output. Based on the current reading of Barron's Business Index one is forced to conclude that either (a) Barron's Index has ceased to function or (b) we are now in a recession which by Barron's measurements, is already almost as deep as the worst of the 1957-58 period.

In view of this one might well ask why the "recession" has not gained some recognition in the nation's press. My answer is that during certain periods the country seems to sink into a state of euphoria or delusion. We saw one such period prior to "Sputnik" when the nation persisted in believing that the



Russians were a generation behind the times. We seem to be indulging in a comparable (economic) delusion today.

I might add that I have never seen "hopes" expressed in print by so many corporate leaders and business groups. One group hopes orders will pick up by September, another group hopes the worst has been seen. The hopes of steelmen have been revised so often that they no longer command financial headlines. The following from Business Week (August 27) probably qualifies as "the hope of the week": "Midsummer ordering trends are always likely to be erratic -- and particularly when summer holds little clue to the future. Thus, July's low level of new business in machine tools may be an accident, not a portent."

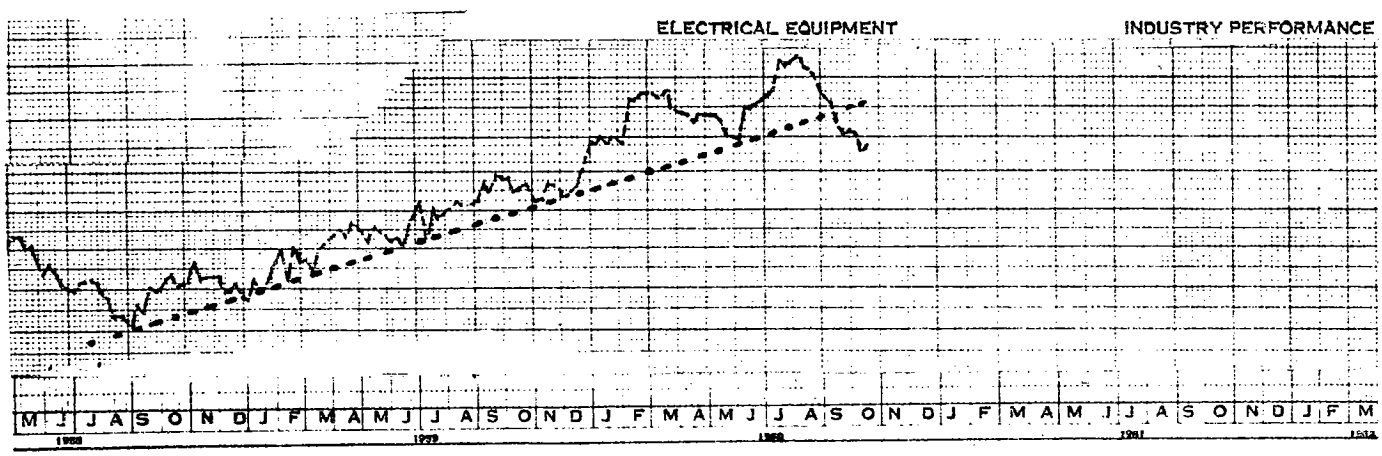
PERSONAL NOTE Writing these Letters over the last number of months has not been a pleasant task. Nobody loves a bear, and nobody loves the bearish view. If the bull goes against the prevailing bearish opinion and is wrong, he is quickly forgiven; if he is right he is heralded as a man of foresight or even genius. If a bear goes against the accepted bullish opinion he is denounced as a destructionist -- the more so if his bearish predictions come true.

Despite bearish opinions expressed in these Letters, I have been told that the renewal rate to this Service continues to be one of the highest in the field, and I wish to take time to thank all those subscribers who have borne with me through the early part of the bear market. Many readers have written words of encouragement; others have been frankly critical. Almost all letters received have been constructive, and I have been surprised and pleased at the knowledge displayed by subscribers in their correspondence. I am now certain that these Letters have succeeded in their primary purpose -- namely, providing businessmen and investors with a fundamental understanding of the principles and philosophy of those three astute gentlemen, Dow, Hamilton and Rhea.

Subscribers should also remember that some day Dow's Theory will again indicate a bullish tide, despite bearish conditions which will be apparent to anyone who is able to read the morning paper. At that time Dow Theorists will probably be denounced anew for being "fools and dreamers". However, if a man has made money in a bull market and kept it through a bear market he has probably already learned to ignore the opinions of others. "I have often noticed," wrote Hamilton, "that the really successful man in Wall Street is curiously inarticulate. Experience has taught him to keep his tongue between his teeth."

NOTE Mr. George W. Bishop has recently completed a book entitled, "Charles H. Dow and the Dow Theory". The book is a 354 page description of Dow, his times and his work. Much of the material in this book has never been seen before, and I believe it is a worthwhile addition to market libraries. Bishop's book is written from the standpoint of a scholar, rather than a market man, and this is perhaps unfortunate. The chapters and numerous quotes from Dow are excellent and highly informative, although I feel that the later chapters on Hamilton, Rhea and the Dow Theory leave something to be desired. For those who want a greater understanding of Dow and the Theory as he originally envisaged it, I recommend this book. By special agreement with the publisher, I have agreed to handle "Charles H. Dow and the Dow Theory" for my subscribers. Price is $6.00, postpaid. Please make checks payable to Richard Russell Associates.

STOCK GROUPS The following chart (courtesy of Traders Research Corporation) is significant in that it shows a sharp downturn in relative strength of the electrical equipment group. For the first time since late 1958 this group is now performing worse than the market. This suggests that the group is being distributed.


ELECTRICAL EQUIPMENT
INDUSTRY PERFORMANCE
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(Written Monday, August 29th - 1 P.M.)